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THE U.S. BUSINESS OUTLOOK

THE STORM clouds gathering for so long on the economic horizon are finally over head. In April, for example, the following signs of recession came showering down:

- Retail sales--off more than 1% from March (down more than 13% at an annual rate).
- Employment--a half million jobs lost between March and April.
- Production--factory output slashed by 1.9% (21% annualized).
- Housing--starts down by 2.1% from the already depressed March level, and 42% below the year-ago figure.

The economy, moreover, is due for a further dampening: Consumers, who propped up the economy last year by borrowing lots and saving little, will cut spending significantly; retail sales will thus continue to fall, leading to a reduction in orders. Looking at lightweight order books, manufacturers will further cut production and lay off more workers; as employment falls, income will fall, causing further cutbacks in consumer spending.

The driving force behind this scenario is a drop in personal consumption expenditures. Therefore, the key

question is: Why should consumers stop behaving as they did last year when they defied economists' logic and kept up a spending spree they really couldn't afford?

Beyond the answer to this question is another question: Once consumers cut back their purchases, and production and employment slumps, why should things stop getting worse and start getting better? In other words, why should the economy recover? The answer to this question will be tackled later. But first, why the recession?

The Consumer Quits At Last

Jolted by the Federal Reserve Board's mid-March credit crackdown, consumers began to think twice about whipping out their credit cards and running up further--now more expensive--debt. The result: The net increase in installment debt in March ($1.4 billion) was well below February's figure ($2.3 billion), and off sharply from March a year ago ($3.6 billion). Consumers' newfound conservatism on credit is expected to continue until they feel liquid enough to handle bigger debt loads.

Besides losing their taste for debt-financed purchases, consumer appetites will also be checked by the big payments they'll be making on previous loans. At the same time, consumers are expected to start worrying about their neglected savings, which last year were sacrificed in the interest of consumption. (The savings rate--savings as a percent of disposable personal income--tumbled to 3.5% in last year's

fourth quarter, the lowest it has been in three decades.) The savings rate rose during the 1969-70 recession and trickled down slightly in the 1973-75 recession. Even at its low point in the last recession, however, it was 6.4%, well above the current rate.

If consumers begin saving at a more normal rate, it means of course that less of their income will be available for purchases. And, in fact, in recent months consumers have started to save more: From 3.4% in December, the savings rate inched up to 3.5% in January; it then jumped to 3.7% in February and 4.0% in March. The bite into retail sales, consequently, may be deep.

However, more important than increased debt payments and higher savings rates as a deterrent to consumer spending will be a drop in income, caused by a reduction in employment. True, most people will continue to work right through the recession. But for the economy as a whole, income will not be as high as it would have been with higher levels of employment; and when inflation is taken into account, personal income for the economy as a whole will be falling. Moreover, recession will put a damper on wage increases for those still working. Thus, a disappointingly slow rise in wages may depress spending, as workers decide to wait for better times before parting with cash in hand. Similarly, the publicity which will be given to unemployment may spur some employed workers to save more as a hedge against loss of their own jobs.

In sum, inflation-adjusted personal consumption expenditures are likely to fall steeply this year, especially in the current quarter. With such expenditures accounting for about two-thirds of gross national product (GNP), it is easy to see that a weak consumer means a weak economy.

Housing Bottoms Out

The consumer has just recently begun to retrench. Housing meanwhile has been in the trenches since late last year, suffering heavy casualties.

In April, new houses were being started at an annual rate of just over 1 million, a near 50% plunge from last September's rate. Moreover, starts are forecast to fall further to a 950,000 annual rate in the second quarter, 68% off the first quarter level (at an annual rate).

As a consequence, residential investment (the entry in the GNP accounts) has begun to fall and will continue to drop precipitously, reflecting (with a lag) the collapse in housing starts.

But in contrast to consumer spending, the housing debacle may soon be coming to an end. Mortgage rates, after all, have taken a substantial tumble, bringing monthly mortgage payments within the reach of more people. House prices, too, have been declining: The median price

of a house in February was $65,000; in March it was $63,800.

Lower house prices and lower mortgage rates in and of themselves should stimulate the home ownership urge of many, especially those who have felt shut out of the market by high prospective financing costs.

The decline in mortgage rates, of course, reflects the decline in interest rates generally. And this general decline implies that builders will again start thinking about taking out construction loans. So the housing market should soon be reviving on both the demand and supply sides.

At the same time, the revival may not be dramatic in the near term: Depressed housing markets have resulted in a large overhang of unsold units on the market--10.6 months' worth in March at current sales rates; and not until this stock of homes is whittled down will builders feel strong incentives to put up a flock of new dwellings. Also, budget-conscious consumers in the midst of a recession may decide to delay house purchases until the economic outlook is a little brighter.

Nonetheless, housing is getting set for a rebound.

Capital Spending Tops Out

While consumers have spent themselves out and while housing still has a lot of holes in its roof, there is one sector expected to show strength in the very near term--capital spending.

Typically, as the economy enters a downturn, business expenditure on plant and equipment continues to hold up. For one thing, capital budgets drawn up for the following year tend to reflect the strength or weakness of the economy in the period prior to budget making. Thus, 1980 capital budgets would reflect events in 1979, when continued economic growth may have made firms optimistic about the future.

Optimism may also have been fueled by healthy corporate cash flow--up 6.2% in 1979, after taking out inflation. Since cash flow is an important source of capital project financing, firms may have felt that obtaining sufficient funds for 1980 projects would not present a problem.

In line with this relatively upbeat perspective, nonresidential fixed investment grew faster than the rest of the economy in 1980's first quarter, and is expected to outpace the rest of the economy in the second quarter too. For the year, McGraw-Hill's annual spring survey found that business plans to raise capital expenditures by 12.2%.

However, while capital spending will stay up relative to other sectors in the short run, it will soon react to the weakening of the economy; and as a result, plant and equipment expenditure will turn down later in the year.

Thus, the survey figure of a 12.2% gain seems too high because it reflects the relatively optimistic plans in effect as of the beginning of 1980--plans, that is, not yet adjusted for changes in the economic outlook.

Given the downturn, nonresidential fixed investment is likely to rise this year by about 9½%. With inflation about matching this gain, however, real capital spending in 1980 will at most equal 1979 expenditures.

Looking beyond 1980, capital spending will likely be weak in the first half of 1981, for reasons parallel to those explaining the relative strength in early 1980: Spending plans lag economic events, so the weak 1980 economy will dampen spending in the early part of the 1981 recovery.

The Dynamics of Recovery

All told, real GNP is expected to slump by 3% from the peak of this business cycle (1980's first quarter) to the trough (1981's first quarter). That compares to a 5.9% peak-to-trough plunge in 1973-75 and a 1.1% fall in 1969-70. The 1980 recession, by this yardstick, is thus expected to be moderately severe.

As the economy moves through recession, however, and as rising unemployment sparks dire warnings of Depression in newspapers and magazines, the recession may seem severe

indeed. So severe, in fact, that the possibility of a 1981 turnaround may appear slim. Why, then, should the economy perk up in the first part of 1981?

One boost to economic activity could come by way of government--either increased spending or a tax cut or a combination of both. As election time approaches, some stimulus is to be expected.

However, even if politicians stick to their new-time religion of fiscal conservatism, the economy will still turn the corner in 1981.

First in line on the recovery list will be the housing industry. As discussed above, cautious home seekers will be lured into the market by declining mortgage rates and house prices. As sales pick up and the inventory of unsold homes is pared down, builders will increase their activity, while at the same time they will be able to get lower-cost construction loans.

A rise in residential building is important to recovery in and of itself because the industry employs so many people (about 700,000 at the end of last year). But in addition, increased house and apartment construction gives rise to demand for home-related products like furniture, rugs, and appliances. Demand for these products, in turn spurs demand by their manufacturers for basic materials--lumber,

textiles, steel. These latter industries then increase production and hire more people, which leads to increased incomes. The circuit then continues to the retailers, who experience a rise in sales and who consequently place more orders and hire more people.

Thus, the entire economy will get a lift from the housing industry's revival.

As a share of GNP, however, residential construction is only about 5%--hardly an insignificant number, but not big enough to handle the job of turning the economy around all by itself. Moreover, the other fixed investment sector--nonresidential--will be slumping at the end of 1980 and beginning of 1981; and since nonresidential investment is much greater than residential, the net contribution of fixed investment to recovery will be small.

More crucial to recovery than housing will be consumer spending, which accounts for two-thirds of GNP. Consumer spending will, of course, be stimulated by improvements in the housing market, as described above. But other forces will also be at work.

In the near term, consumers are expected to tighten their belts in order to pay off debts and accumulate savings, thereby bringing on a recession. The corollary is that once consumers feel liquid again--once, that is, they can stop worrying about how to pay the bills due tomorrow--they

can begin thinking again about making purchases. In particular, they can think about buying expensive items--like autos--which were the first things cut from consumer budgets. A pickup in consumer purchases of durable goods, then, should be a key element in the 1981 economic turnaround.

Once consumer spending starts to rise, the whole chain of events leading to increased employment and incomes proceeds, with increases in incomes boosting consumption even further.

Besides feeling ready to take on more debt in 1981 (due to improved liquidity), consumers will also be induced to borrow by relatively low interest rates. Interest rates have already fallen sharply since mid-April and are likely to fall further for at least two reasons: One, the Federal Reserve Board has begun to ease its credit restrictions and will probably ease them further. Two, as the recession wears on, business loan demand will lessen as capital projects are delayed and inventories are reduced in line with sales. If the Fed decides to loosen its grip on the money supply, interest rates could fall even further.

In 1981, then, the stage will be set for consumer belt loosening.

Summary

After being buoyed up for so long by continued consumer spending, the economy fell into recession with a thud in the second quarter of 1980. Several more quarters of negative economic growth will follow, as consumers try to reduce debt and increase savings, and as business curtails capital spending.

Meanwhile, the drop in mortgage rates and house prices will be setting the stage for a recovery in residential construction. Increased house building will spur employment and income, which in turn will stimulate retail sales and the economy in general.

Somewhat later, but with more power, consumers will begin loosening their pursestrings and seeking more credit. The reason: Savings will be deemed sufficient, interest rates will be declining, and monthly credit payments on old debt will no longer be prompting domestic crises. In short, consumers will have regained confidence, and the economy will consequently resume positive real growth.

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NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars)

	Actual	Forecast					Annual	
	1980	1980			1981			
	1Q	2Q	3Q	4Q	1Q	2Q	1979	1980
National Product Accounts								
Gross National Product	2516.1	2537.0	2569.0	2619.0	2675.0	2758.0	2368.8	2560.3
Consumer Spending	1628.7	1635.0	1665.0	1700.0	1742.0	1801.0	1509.8	1657.2
Gross Private Domestic Investment								
Fixed Investment	384.0	386.0	376.0	374.0	377.0	392.0	387.2	380.0
Nonresidential	273.3	279.0	281.0	282.0	283.0	284.0	254.9	278.8
Residential	110.5	92.0	82.0	85.0	91.0	101.0	114.1	92.4
Inventory Change	0.1	15.0	13.0	7.0	3.0	7.0	18.2	8.8
Government Purchases	517.4	528.0	538.0	554.0	565.0	577.0	476.4	534.4
Federal	186.2	191.0	195.0	205.0	210.0	215.0	166.6	194.3
State & Local	331.2	337.0	343.0	349.0	355.0	362.0	309.8	340.1
Net Exports	- 14.0	- 12.0	- 10.0	- 9.0	- 9.0	- 12.0	- 4.6	- 11.3
Real GNP (1972 dollars)	1442.6	1420.5	1405.4	1399.8	1397.6	1409.3	1431.6	1417.1
(% change at annual rate)	0.6	- 6.0	- 4.2	- 1.6	- 0.6	3.4	2.3	- 1.0
Implicit Price Deflator								
(% change at annual rate)	9.3	10.0	9.8	9.7	9.5	9.3	8.8	9.3
Key Economic Indicators								
Unemployment Rate (percent)	6.1	7.5	8.3	8.5	8.6	8.3	5.8	7.6
Housing Starts (thousands of units)	1263	950	1000	1100	1200	1400	1745	1078
Consumer Price Index								
(% change at annual rate)	16.9	13.5	10.2	9.1	8.9	10.5	11.3	13.6